MEMORANDUM

TO: Board of Supervisors
FROM: John M.W. Moorlach, Supervisor, Second District
DATE: July 20, 2007
RE: Rescission of the AOCDS Retroactive Pension Benefit

Dear Colleagues:

The purpose of this memorandum is to place on the July 31, 2007 Board of Supervisors' Agenda, and ask that you support, a series of recommended actions (presented here with supporting data and analysis) in connection with the Association of Orange County Deputy Sheriffs (AOCDS) retroactive pension increase granted by the Board of Supervisors by way of an amendment to an MOU in December, 2001.

I strongly recommend that we pursue the following recommended actions:

RECOMMENDED ACTIONS:

1. Rescind, as void and in violation of Article IV, Section 17, Article XI, Section 10(a), Article XVI, Section 6, and Article XVI, Section 18 of the California Constitution, the retroactive portion of the "3% at 50" pension increase to all Public Safety employees who received such retroactive increase as part of the Amendment to the MOU with the County of Orange approved by the Board of Supervisors on December 4, 2001 (made effective June 28, 2002), except that members who retired after such retroactive increase took effect shall not be required to repay any pension payments representing the retroactive increase that they have actually received since the MOU was approved and implemented, but shall only be ineligible to receive payments attributable to such retroactive increase going forward;

2. Employ counsel to immediately file a Declaratory Relief action in the Orange County Superior Court against AOCDS and the Orange County Employees Retirement System (OCERS), confirming the rescission, seeking a judicial declaration that the retroactive portion of the "3% at 50" pension increase to members of AOCDS violates the debt limitation provisions, is a gift of public funds, and is extra compensation paid to public employees, all in violation of Article IV, Section 17, Article XI, Section 10(a), Article XVI, Section 6, and Article XVI, Section 18 of the California Constitution, and that the County of Orange has no obligation to make any further payments toward the retroactive portion of the pension increase, and enjoining further payments by OCERS of the portion of payments to retirees based on the 1% retroactive portion; and

3. Direct the CEO and/or County Counsel to send a letter to the Chief Executive Officer of OCERS informing him or her that the Board of Supervisors considers the retroactive portion of the "3% at 50" pension increase to all members of the AOCDS pursuant to the Amendment to the MOU with the County of Orange approved by the Board of Supervisors on December 4, 2001 unconstitutional and void, that the County of Orange will not include as its future payments the retroactive increase, requesting that OCERS immediately calculate the required future payments based on a "2% at 50" rate through the effective date of the Amendment to the MOU and a "3% at 50" rate thereafter, and that OCERS immediately begin paying retirement benefits to retirees applying a "2% at 50" formula to their service through the effective date of the MOU and a "3% at 50" rate thereafter, if an AOCDS member continued to work after the effective date of the MOU.

BACKGROUND INFORMATION:

As of June 30, 2001, the Orange County Retirement System was approximately 103.74% funded. During 2001, the County improved benefit offerings by amending a then-current MOU and agreeing to pay Public Safety Law Enforcement employees a "3% at 50" retirement multiplier for *all years of service* (both past and future) (Orange County Resolution # 01-410, Orange County Board of Supervisors Agenda, December 4, 2001). The MOU that was amended had been executed in October, 1999, and was not due to expire until October, 2002, but was amended pursuant to a reopener clause. The amendment was made effective as of June 28, 2002. The inclusion of "all years of service" made the "3% at 50" multiplier retroactive, pursuant to authority purportedly granted to counties, cities, and districts by the Legislature in Government Code Section 31678.2, enacted in 2000.

Law enforcement employees had been paying into the retirement system under the assumption that they would be receiving a lower retirement multiplier. Thus actuarially, this change created a significant liability for which there had been no pre-funding. The burden of paying down the unfunded liability fell entirely on the shoulders of the County General Fund. The amendment to the Memorandum of Understanding incurred in one year an immediate unfunded liability of somewhere between $100 million and $300+ million (depending on the accuracy of the retirement pattern assumptions) that was to be paid out of the General Fund income or revenue of future years. When the amount of the anticipated unfunded liability resulting from the increased benefits was presented to the Board on November 20, 2001, it was based on an assumption that there would be no change in retirement patterns. This was demonstrably wrong, based on the experiences of other jurisdictions and, predictably, the actual retirements that ensued were consistent with a much heavier retirement pattern. Using that assumption, the actuarially determined unfunded liability may have exceeded $300 million.

The Auditor-Controller has determined that the excess revenue over expenses was, at all times during FY 2001-02, less than even the $100 million liability created by the amendment to the MOU: gross excess revenues were $48.5 million pre-transfers, and $29 million post-transfers. These amounts take into account the availability of prior years' fund balances as revenue.

Since, prior to the adoption of the amendment to the MOU, Public Safety employees had been accruing pension benefits under a series of MOU's at 2% at 50, the addition of the retroactivity

of the 3% at 50 formula meant that, as of the adoption of the amendment to the MOU, Public Safety employees who had completed and performed services up to that point received extra compensation in the form of 1% of their final year's pay for every year that they had already worked, without having performed, or promised to perform, any further services. Indeed, shortly after adoption of the amendment to the MOU, as alluded to above, a number of those eligible to retire at 50 years of age did so, and were afforded the 3% calculation on their pension benefits for their entire employment history, without any requirement of additional work or commitment.

RATIONALE FOR RECOMMENDED ACTIONS:

Recent legal analysis performed by our office and by independent counsel retained by the County demonstrates that the retroactive pension increase, paid for almost entirely out of General Fund money, violates the California Constitution in several respects: (1) it violates the debt limitation of Article XVI, Section 18; (2) it is a gift of public funds in violation of Article XVI, Section 6; and (3) it is extra compensation to public employees who already performed the services for which they were compensated, in violation of Article IV, Section 17 and Article XI, Section 10. Because this retroactive increase was unconstitutional and thus illegal, it must be rescinded. Any one of the three grounds will suffice for rescinding the retroactive increase.

1. The retroactive portion violates the debt limitation

Article XVI, Section 18 of the California Constitution provides that, "No county ... shall incur any indebtedness or liability ... for any purpose exceeding in any year the income and revenue provided for such year, without the assent of two-thirds of the voters of the public entity voting at an election to be held for that purpose ...."

The retroactive pension increase was never approved by the voters of the County. When the Board of Supervisors voted on December 4, 2001 to award the retroactive pension increase to Public Safety members, it immediately incurred for the County, solely as a result of that award, an unfunded actuarial accrued liability of at least $100 million, and, using proper retirement pattern assumptions, an unfunded actuarial accrued liability of as much as $300 million or more.

Pension obligations have been consistently held by the Courts to be indebtedness and liabilities. *See, e.g., San Francisco Taxpayers' Association v. Board of Supervisors*, 2 Cal. 4th 571,578, 828 P.2d 147,150, 7 Cal. Rptr. 2d 245,249-50 (1992). A recent California Court of Appeal case held that they are the type of liability that can violate the debt limitation. *State ex rel. Pension Obligation Bond Committee v. All Persons Interested, etc.*, 2007 Cal. App. LEXIS 1111, *32-*33 (July 3, 2007). The purpose of the debt limit provision of the California Constitution, which generally precludes a municipality from incurring a debt or liability exceeding its income and revenue for a given year, is to establish a "pay as you go" principle as the cardinal rule of municipal finance, and to ensure that the actual cost of municipal government is closely reflected in the tax rate and give the people the ultimate power of approving or rejecting projects requiring long-term expenditures. *Westbrook v. Mihaly,* 2 Cal.3d 765,776, 471 P.2d 487,494, 87 Cal. Rptr. 839,846 (1970), *vacated on other grounds,* 403 U.S. 915 (1971).

If, to any extent, the liability created at the inception of the contract for pension benefits cannot be paid from the income and revenues of the then-current year, and is thus payable, even in part,

from County general funds in a future year, the contract for pension benefits violates Article XVI, Section 18 of the California Constitution.

Because the County incurred a liability in FY 2001-02 that it could not pay through current year revenues, but instead must pay from the General Fund in future years irrespective of the actual revenues in those years, it would appear that, "the better reasoned view is that the retroactive benefit increase violated the debt limitation when it was approved by the Board of Supervisors."[1]

In order to avoid the debt limitation, the entire liability must be payable from the current year's (FY 2001-02) revenues. The California Supreme Court has held that whether the debt limitation was violated depended upon whether there were unappropriated revenues sufficient to pay the liability in the year in which the liability was created. *Los Angeles County v. Payne*, 8 Cal. 2d 563 (1937). The County Auditor-Controller has recently determined that in FY 2001-02, even accounting for unappropriated revenues and fund balance available, the total revenue over expenses was between $29 million and $48 million—significantly less than the $100 million minimum unfunded liability created by the retroactive increase in AOCDS benefits. Therefore, the retroactive pension increase, paid for entirely out of General Fund money, violates the California Constitution's debt limitation.

None of the narrow exceptions to the debt limitation prohibition apply.

One, the *Offner-Dean* rule, only applies to contingent, installment liabilities, so that future years' obligations only arise if consideration for those obligations arises. The most common example of this is a lease—there is no rent obligation until and unless the tenant has possession. Here, the payments funding the liability are mandatory, and must be made irrespective of the County's other income and expenses. Thus, if the pension liability exceeds available revenue in any given year, other expenditures and programs must be cut out to pay for this "vested" obligation.

Another exception is for payments made from a special fund other than the General Fund, which provides a separate income stream out of which the entire liability will be paid. That is not the case here. All payments on the retroactive pension liability are to be made from the General Fund.

The third exception is for obligations imposed by law. For some time, this issue was the most uncertain, although we felt that, at best, the legislation made retroactive pension benefits merely an option—not a mandate. However, the California Court of Appeal held just this month in *State ex rel. Pension Obligation Bond Committee v. All Persons Interested, etc.*, *supra*, that pension obligations are ***not*** obligations imposed by law, and that the State's issuance of Pension Obligation Bonds without voter approval violated the State constitutional debt limitation. The Court of Appeal held that the analysis under both the State debt limitation at issue in that case (Article XVI, Section 1) and the local government debt limitation at issue here (Article XVI, Section 18) are, with respect to the question of the nature of the obligation, similar. Specifically, the Court of Appeal held: "neither the 1930 authorization to create a pension system nor the California Pension Protection Act of 1992 created an obligation to fund retirement benefits. The 1930 authorization was just that, an authorization. It did not bind the Legislature to create a

[1] "Legal Analysis of the Enhanced Benefit Formula for Safety Employees Under the Orange County Employees Retirement System," prepared by Bruce Ashton, Esq. of Reish Luftman Reicher & Cohen, June 12, 2007.

pension system and, a fortiori, did not bind the Legislature to fund such a system." Certainly, at most, the Legislature merely authorized retroactive benefits—it did not mandate them. Thus, it cannot reasonably be argued that the retroactive pension benefits are obligations imposed by law.

Finally, both staff and independent counsel also concluded that the validation action on the Pension Obligation Bonds did not preclude taking this position, since the validity of the retroactive pension increase was not a proper subject of a validation action.

Thus, under this reasoning, the retroactive portion of the pension benefits increase to AOCDS members is unconstitutional under Article XVI, Section 18 of the California Constitution as it has been interpreted by subsequent case law, and must therefore be rescinded.

There are, however, other grounds for rescission in the California Constitution.

2. *The retroactive portion is an unconstitutional gift of public funds and extra compensation to public employees after services were rendered*

Article XVI, Section 6 of the California Constitution provides that, "The Legislature shall have no power to make any gift or authorize the making of any gift, of any public money or thing of value to any individual, municipal or other corporation whatever ..."

Article IV, Section 17 of the California Constitution provides that, "The Legislature has no power to grant, or to authorize a ... county ... to grant, extra compensation or extra allowance to a public officer, public employee, or contractor after service has been rendered or a contract has been entered into and performed in whole or in part ..."

Article XI, Section 10(a) of the California Constitution similarly provides that, "[A] local government body may not grant extra compensation or extra allowance to a public officer, public employee, or contractor after service has been rendered or a contract has been entered into and performed in whole or in part ..."

Courts have routinely held that, "A pension is a gratuity when it is granted for services previously rendered and which at the time they were rendered gave rise to no legal obligation ..." *Lamb v. Board of County Peace Officers Retirement Commission of Los Angeles County*, 29 Cal. App. 2d 348, 84 P.2d 183 (1938). Here, the retroactive portion was granted in December, 2001 (effective June, 2002), for services explicitly rendered before those dates. Indeed, the Personnel and Salary Resolutions adopted at the same time as the Amendment to the MOU specifically make adjustments based on whether employees were hired before or after September 20, 1979—thus making years of past service a basis for the calculation of the benefit. At the time those services were actually contracted for and rendered by AOCDS members, those services gave rise to at most a 2% at 50 obligation, not a 3% at 50 obligation. Thus, the retroactive pension increase gave AOCDS members an extra 1% for each year of service they had already performed by June 28, 2002. At the time those services were rendered, there was no legal obligation to pay retirement benefits at more than 2% for each year of service. Thus, the additional grant of 1% for each year of service was a gift of public funds, and thus void as unconstitutional.

In addition, the grant of the extra 1% for each year of service that AOCDS members had already performed by June 28, 2002 violated the prohibition on extra compensation to public employees "after service has been rendered or a contract has been entered into and performed in whole or in part ..." The retroactive 1% was certainly "extra" compensation—it was extra over and above the 2% per year that had been agreed upon for years. It was given after service had been rendered, because it was retroactive—which on its face means that the compensation was given after the services had been rendered by AOCDS members. It was also given after the contracts had been performed in whole or in part—it was given for years of service under prior MOU's, and explicitly by amendment under the then-current MOU which, by then, had been performed in part since October, 1999.

The Legislature is barred from authorizing a county, city or district to grant such extra compensation under Article IV, Section 17 of the California Constitution, so Government Code Section 31678.2 is an unabashed, and unconstitutional, attempt to grant a gift of public funds, and extra compensation, to public safety (and other) employees by its grant of retroactive benefits.

Moreover, counties, cities, and districts are themselves directly barred from granting such extra compensation under Article XI, Section 10 of the California Constitution (adopted in 1970), so Resolution 01-410 was unconstitutional when it was adopted.

These sections have been interpreted fairly strictly by the courts. Courts have routinely stricken down retroactive additional compensation where the additional compensation was for services for which a definite compensation had been agreed upon at the time. As examples, the courts have disallowed forfeited overtime credits, unused vacation time, back pay for a period in which a teacher had been wrongfully suspended, and similar attempts to retroactively award various types of benefits. Here, under every prior MOU to the reopener of December, 2001, the services performed under those MOU's were performed in order to earn a certain pension benefit—2% at 50. Thus, the retroactive pension increase was a grant of extra compensation for services after the services were rendered and after the contract under which the services were performed was both entered and performed, and thus void as unconstitutional.

Nor can it be argued that AOCDS members "bargained away" something in exchange for the retroactive portion. The sole purpose of the reopener was to take advantage of the 3% at 50 and retroactivity provisions authorized by the Legislature, and not to bargain over other issues. Indeed, the increase was sold on the notion that, without it, recruitment and retention would be more difficult when other jurisdictions offered 3% at 50. But retroactivity added nothing to recruitment or retention, since when there is no prior work history with the County or any other agency, retroactivity does not amount to anything. Furthermore, there is no evidence of any *quid pro quo* on the retroactivity issue. This appears to be nothing more than a grant of the benefits because the Legislature purported to give the County the authority to grant the benefits, and every other agency was doing so.

Unlike retroactive increases to then-current employees, additional benefits may constitutionally be provided for members of the [retirement] system who have acquired a "pensionable status." "Pensionable status," as is clear from the language and the focus in the cases, refers to those who can already receive a pension—those who have already retired. *See, e.g., Nelson v. City of Los Angeles*, 21 Cal. App. 3d 916,918-19, 98 Cal. Rptr. 893-94 (1971) (if it were not for the retiree

status, the increase even in future benefits would have been an unconstitutional gift of public funds). However, the recipients of the retroactive pension increase from the County of Orange were not retired at the time they were granted the retroactive increase, and could not have been, because state law (Government Code Section 31678.2) barred the award of retroactive benefits to retired employees. Thus, the retroactive pension increase was based solely on service time, because it was an increased retroactive percentage for each year of service time. Since, at the time the retroactive increase was granted, it was granted, not based on pensionable status but explicitly based on service time, the retroactive increase did violate the Constitutional prohibition on the payment of extra compensation for services rendered. For this reason as well, the retroactive portion of the pension benefits increase must be rescinded.

3. At most, those employees who retired in "reliance" on the retroactive benefit are entitled to keep the payments they have received

Case law suggests that those employees who retired in reliance on the retroactive benefit will only be entitled to keep the payments they have received, but all future benefits would be reduced to the "2% at 50" level earned through December 2001. In a case involving an erroneous reclassification of public safety officers, where the Board, on discovering the error, reclassified the officers, the Court of Appeal estopped the reclassification only before the Board decision, but not after. Thus, the retirees were able to retain the benefits already paid to them but not continue to receive the enhanced benefits. In so holding, the court relied on public interest and policy principles, saying these principles would be "...adversely affected if petitioners, despite the discovery of the mistaken classification, ...continued to be carried as local safety members when all other contract members of the retirement system throughout the state performing like duties and functions are classified as miscellaneous members." *Crumpler v. Board of Administration Emp. Retirement System*, 32 Cal. App. 3d 567, 108 Cal. Rptr. 293 (1973). There, employees had no vested right in an erroneous classification, and here AOCDS members had no vested right in an unconstitutional gift of extra compensation. Here, then, those AOCDS members who retired after the effective date of the MOU amendment but prior to the rescission would also retain the payments already made to them, but could not receive the additional 1% per year in the future. Thus, an injunction that would enjoin OCERS from henceforth paying benefits based on 3% at 50 levels for the pre-December 2001 period is an appropriate remedy.

4. We estimate savings of from $184 to $550 million.

While the exact savings from rescinding the retroactive portion are not precisely calculable, and more precise calculations would require in-depth analysis from OCERS, our office calculates that, even assuming only a $100 million unfunded liability as created in December, 2001, the overall savings in the remaining 24.5 years of amortization of the liability would amount to, conservatively, $183,750,000. If, in fact, the unfunded liability, due to actual retirement patterns, is $300 million, the savings may well approach $550,000,000.

5. There is no requirement to meet and confer.

Staff and independent counsel concur that, where the Board seeks to rescind an illegal provision, there is no requirement to meet and confer concerning that action.

Government Code Section 3505 generally requires that, "the public employer and recognized employee organization have a "mutual obligation personally to meet and confer promptly upon request by either party … and to endeavor to reach agreement on matters within the scope of representation prior to the adoption by the public agency of its final budget for the ensuing year." Government Code Section 3504 defines "scope of representation" to include "all matters relating to employment conditions and employer-employee relations, including, but not limited to, wages, hours, and other terms and conditions of employment, except, however, that the scope of representation shall not include consideration of the *merits, necessity, or organization* of any service or activity provided by law or executive order." (*emphasis added*)

If an action is taken pursuant to a fundamental managerial or policy decision, "it is within the scope of representation only if the employer's need for unencumbered decision making in managing its operations is outweighed by the benefit to employer-employee relations of bargaining about the action in question." *Building Material & Construction Teamsters' Union v. Farrell*, 41 Cal. 3d 651, 715 P.2d 648, 224 Cal. Rptr. 688 (1986). Here, while the County cannot be encumbered in following the California Constitution, there is nothing to bargain about: because the retroactive increase is unconstitutional, and the County and the Public Safety employees cannot bargain away a challenge to the increase's constitutionality. This is true both because: (1) as public employees, the Board members and the Public Safety employees swore an oath to defend the California Constitution, so agreeing to keep an unconstitutional provision in place violates that oath; and (2) taxpayers also have a right to sue to enforce the California Constitution and void the retroactive increase, so any bargaining in the face of a possible taxpayer challenge is fruitless. Simply put, there is no benefit to employer-employee relations of bargaining where there is nothing to bargain. Thus, there is no benefit to employer-employee relations of bargaining about the rescission because the County simply cannot bargain to accept an unconstitutional provision.